

SURFING THE COMING WAVE OF REGULATORY REFORMS

A joint study on the US banking industry



Turning the tide

Banks and financial services institutions face unprecedented risk and compliance challenges – and in an economic environment that's putting increasing pressure on these businesses to cut costs and boost the bottom line. This white paper, produced jointly by Compliance Week and Wipro Technologies, offers insights into how leading financial-industry players are tackling these challenges, in particular from the IT perspective. While institutions are following their own paths, there are some unmistakable trends, according to our global survey and interviews with Wipro executives. Among the key developments include a drive towards improving data quality, increasing centralization of risk and compliance function, and a rising tide of the outsourcing of risk and compliance activities and related IT services.

When the waves are higher

Whether it's triggered by the near-collapse of LTCM, dot-com enthusiasm or mortgage mania in Orange County or Asia, where there's a financial crisis, there will be more regulation and oversight when the dust settles. But never have regulators in so many countries been poised to demand so much exactitude and detail from so many firms. The Great Recession, as the downturn that began in 2008 is now known, has unleashed in a phalanx of regulations, promulgated under the direction of the U.S. Dodd-Frank law, the European Markets in Financial Instruments Directive II (MiFID II), and the Bank of International Settlements' Basel III requirements, among others. In G20 countries alone, the financial industry has been showered with more than 10,000 pages of regulations, according to Wipro's count.

The specifics are, in many cases, just now coming into focus. For example, in December 2011, the U.S. Federal Reserve proposed 173

pages of new rules relating to stress tests, capital requirements, board oversight and many other issues spelled out in the Dodd-Frank Act. Member states continue to publish drafts of regulations based on Basel III international regulatory framework for banks – even as Basel II and Basel 2.5 remain works in progress in many countries.

"If the details remain murky, the broad outlines of this storm are clear," says Mohan Bhatia, who heads Wipro's global risk and compliance practices. "Regulators around the world have sharpened their focus on risk management, balance sheet structure, business models, codes of conduct, the quality of internal due diligence, and the effectiveness of internal controls – not to mention the corporate governance processes at banks and financial institutions," he says.

"This has resulted in an increase in regulatory prescription in the areas of risk management, capital, liquidity, balance-sheet leverage, customer protections, market integrity, and fairness and transaction analysis," Bhatia says. "Regulatory pressure is, ultimately, deepening the relationships between risk and financial performance, making the reconciliation of risk and finance a defining issue for the industry. Capital, liquidity and fund-transfer pricing are unifying links," Bhatia adds.

Adding to the challenge is the business environment itself, in which profits have yet to return to pre-2008 levels and where ongoing turmoil in global financial markets continues to pressure margins. "All this impacts financial institutions' ability to invest in revamping their risk and compliance regimes," Bhatia says. "Making things worse," he adds, "is that the IT-related outlays needed to upgrade risk and compliance attracts a 100% risk weighting from regulators, making it particularly costly capital for institutions already feeling the financial heat and rising equity-to-capital ratio requirements."

"In the past, when they went through a crisis, institutions went bankrupt, but the business model did not change, so profitability didn't change," Bhatia says. "Now, changes in regulatory requirements are combining to severely impact business models."

Clearly, the industry must react and adapt. Here's how it's doing.

Drivers of a Risk-Compliance Crisis

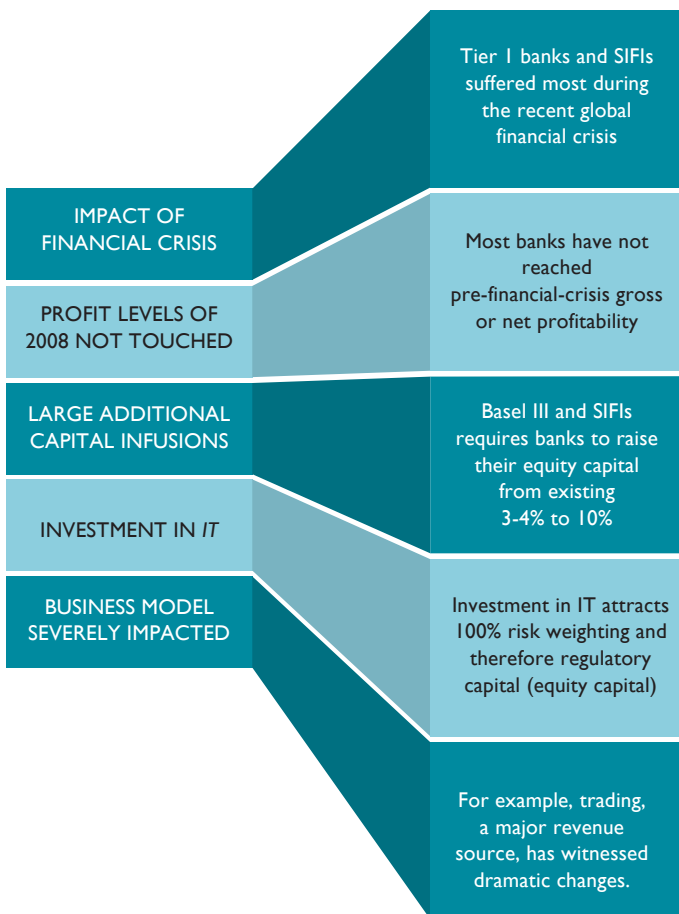


Figure-01

The industry response: a work in progress

For this white paper, Compliance Week and Wipro surveyed managers and executives from 34 financial institutions with annual revenues ranging from less than \$5 billion to more than \$50 billion in the United States, Europe, Asia and the Middle East. They considered roughly a dozen questions about their firms' philosophies and actions taken to deal with intensifying oversight, where regulators want more data, faster, and with a unified view of the regulated entity.

Their responses show an awareness of a need to change, and in many cases banks, financial institutions and insurance companies are moving forward. But universally, there's work to be done.

Roughly 40% of respondents have yet to start reflecting the changing compliance demands of Dodd-Frank or Basel III in their IT systems; a quarter of respondents are in the planning stages.

Respondents reported several key barriers to improving their IT compliance programs to face new financial regulation. Ultimately, a combination of factors appears to be at play. In particular, siloed compliance and risk-management functions combined with a mercurial regulatory environment are stressing banks' ability to keep up, both in terms of manpower and cost.

Changes to IT Systems for Dodd-Frank Compliance

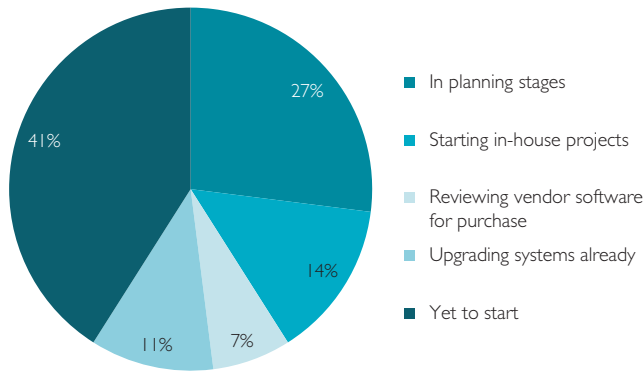


Figure-02

Changes to IT Systems for Basel III Compliance

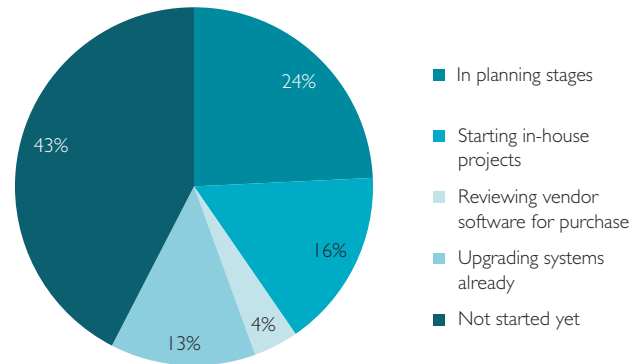


Figure-03

Biggest Barriers to Better Compliance IT Programs

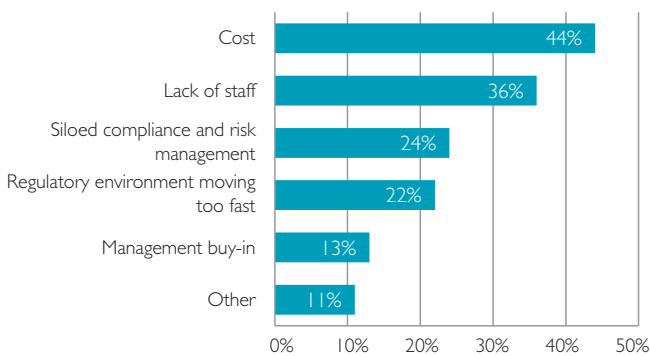


Figure-04

Incorporating Risk Measures into Financial Performance

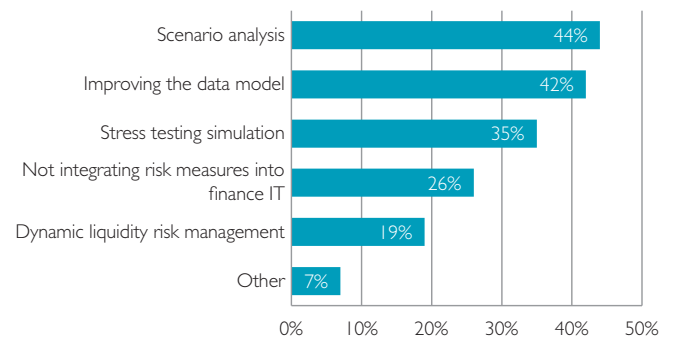


Figure-05

Fully three-quarters of those surveyed are adding systems to incorporate risk measures into financial performance. In addition to fundamental efforts to improve data models, efforts include enabling scenario modeling, stress-test simulations and dynamic liquidity risk management.

Movement Towards a Centralized Risk and Compliance Organization

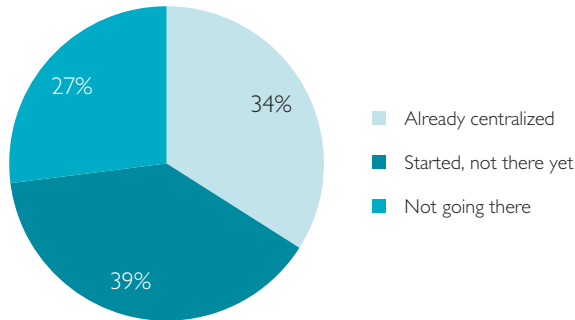


Figure-06

More than two-thirds of respondents either already have or are moving towards centralized risk and compliance organizations. There doesn't appear to be a single industry-standard approach in achieving this organizational unity just yet. Rather, a sizable minority of those surveyed identified several factors, including integrating risk measures

Centralized/Federated Compliance IT Program Status

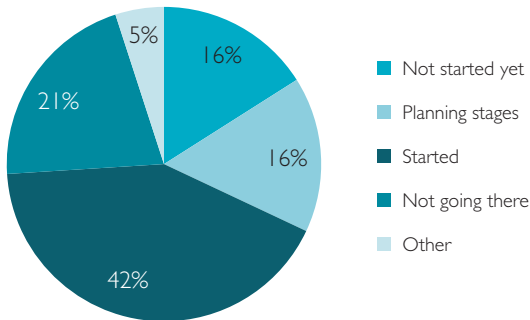


Figure-08

While three-quarters of respondents say they're moving towards more centralized/federated IT for managing compliance, just 42% are beyond the planning stages. The primary focuses of these efforts appear to be

Progress on Stress Testing of Compliance Systems

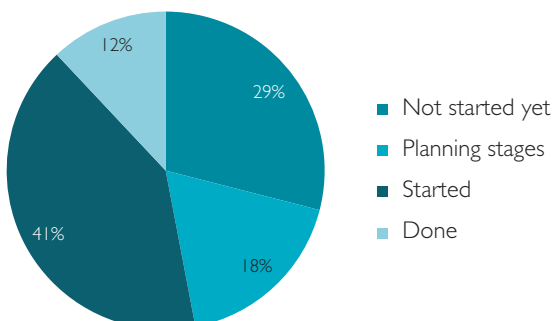


Figure-10

Steps Toward a Centralized Risk and Compliance Organization

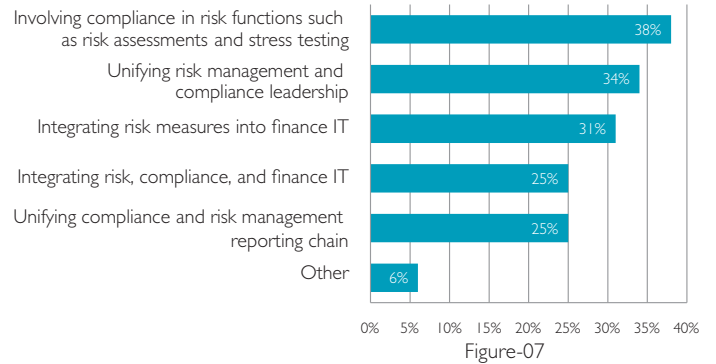


Figure-07

into finance IT; consolidating risk management and compliance leadership and adjusting reporting structures accordingly; incorporating compliance in risk functions such as risk assessments and stress testing; and integrating risk, compliance and IT.

Steps Toward a Centralized/Federated Compliance IT program

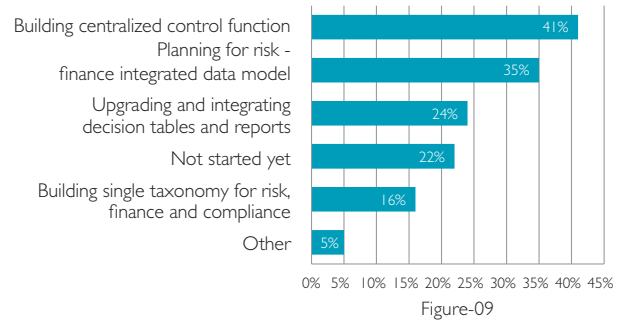


Figure-09

developing a centralized control function, and planning for an integrated risk-finance data model. A smaller minority cited efforts to upgrade and integrate decision tables and reports, as well as creating a unified risk-finance-compliance taxonomy.

Just 12% of respondents had completed the stress testing of compliance systems, with 60% in the planning stages or having started the work. More than a quarter of those surveyed had yet to start the process.

Riding the waves successfully

Banks and financial services institutions and insurance companies must follow their own, unique paths through the regulatory storm, which, as

the graphic shows, confronts the financial industry with an evolving array of complex challenges.

A Complex – and Demanding – Risk and Compliance Landscape

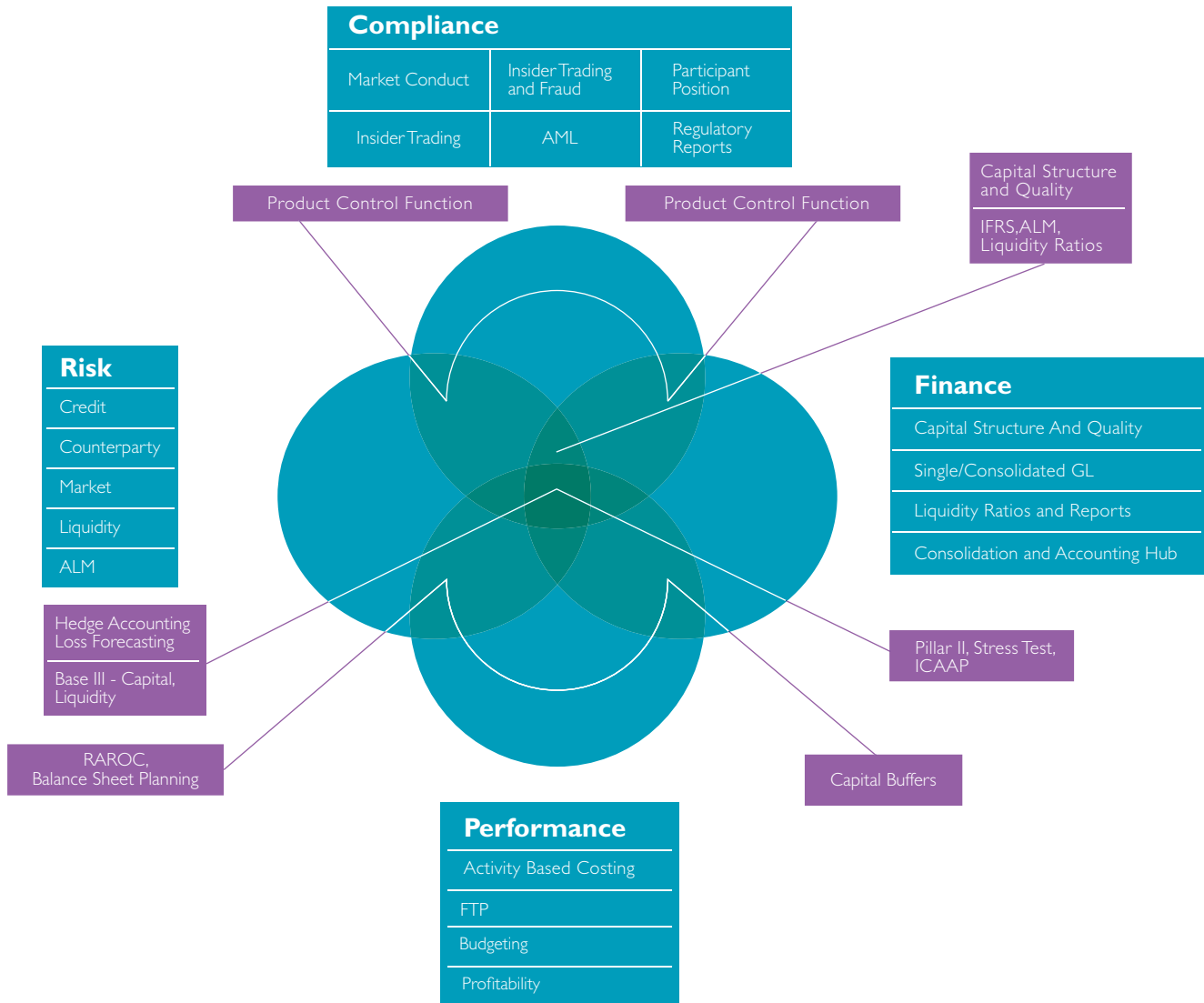


Figure-11

But firms should keep an eye on the prize: deriving business value and increased efficiencies from the very information regulators are demanding.

It's not easy. Wipro believes the combination of converging—and intensifying—regulatory demands and downward pressure on IT

spending and investment amid difficult operating environments are converging data, applications and reporting across risk, finance, performance and compliance. That, in turn, is driving five factors shaping the industry's response to the risk-and-compliance storm.

Pressures on Risk Drive Focus on Utility-Based Model, Data Quality

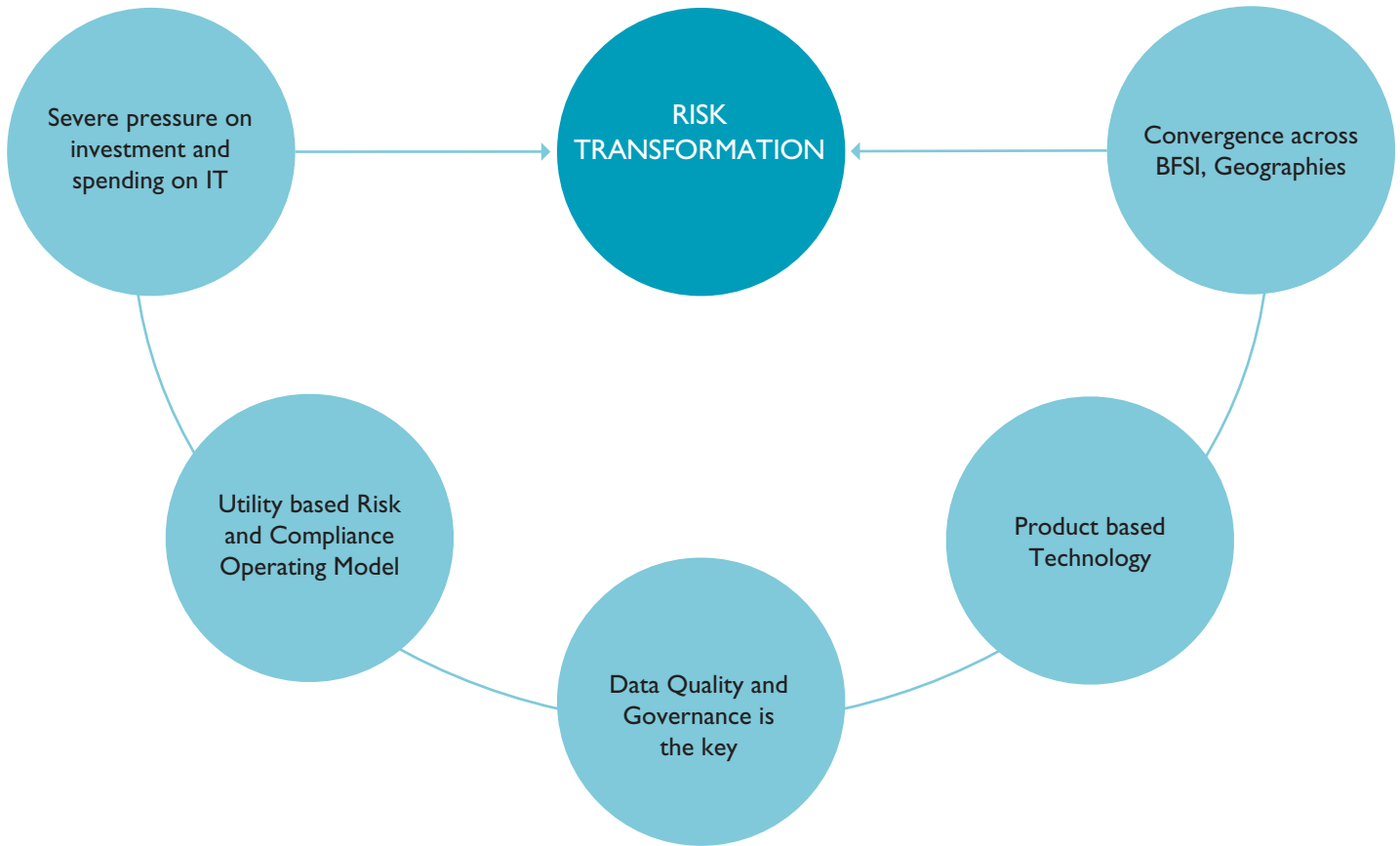


Figure-12

1) The transition of risk IT from support to a business function

Wipro estimates that integrating risk IT into mainline systems not only provides the data regulators increasingly demand, but it can also save 1% to 1.5% of regulatory capital. In addition, the needs of stress testing and liquidity risk management (LRM) force IT into more central roles in financial businesses.

2) A focus on data quality “Data quality and data aggregation pose serious challenges to banks and financial institutions,” Bhatia says.

“Existing applications and technologies can’t be scaled up to the enterprise level,” he says, “and the applications lack the flexibility to cover the broad requirements of diverse national and international requirements.”

“Banks and a wide array of financial institutions would be well-served by implementing data-quality and governance frameworks with the aims of improved data aggregations, higher reporting quality, and more fine-tuned dashboards and information—for regulators as well as for management,” Bhatia says.

3) Centralization of the risk and compliance functions Risk and compliance-function centralization can happen in a couple of ways. One involves unifying risk and compliance functions within the individual organization’s management and reporting hierarchy—which involves improvements to reporting systems themselves. According to our survey, this transition is already well underway, as are efforts to move to more centralized, federated compliance IT programs.

“The single greatest challenge banks are facing in compliance is data quality,” adds Sriram Srinivasan, SVP, Global Banking & Financial Services Business Head, Wipro Technologies

Status of Compliance Reporting System Upgrades

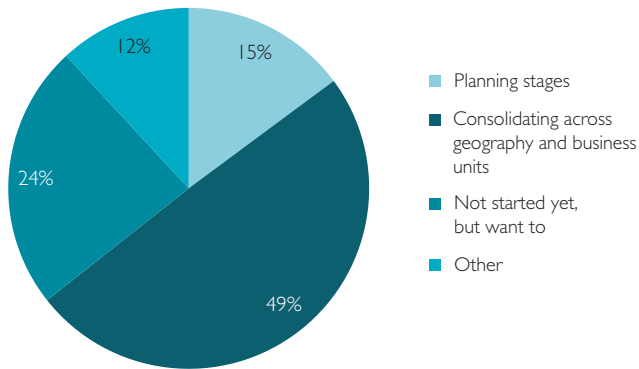


Figure-13

Half of respondents are improving their compliance reporting systems through consolidation across geographies and business units. Another 39% are either in the planning stages of improving compliance reporting capabilities or would like to do so.

Many organizations are taking consolidation a step further. Once centralized, many risk and compliance functions are ripe for outsourcing, both in the traditional sense and, increasingly, via a utility model in which risk and compliance is purchased as a service.

4) The rise of risk and compliance utilities Two factors are steering firms—in particular, the very largest financial institutions—to the utility model. The first is the convergence of risk and compliance regulations across jurisdictions that previously had very little in common—the intention of U.S. regulators to reconcile Dodd-Frank regulations with Basel III's outcomes being a case in point. The second is the mercurial nature of regulations as they evolve—and, presumably, will continue to change over time. Risk-and-compliance-as-a-service, as it were, allows firms to outsource much of the effort needed to keep track of dynamic regulatory environments as well as sharing the costs associated with keeping pace.

“We are seeing increased enquiries on utility for compliance.”

Sriram Srinivasan

Compliance and Reporting Readiness

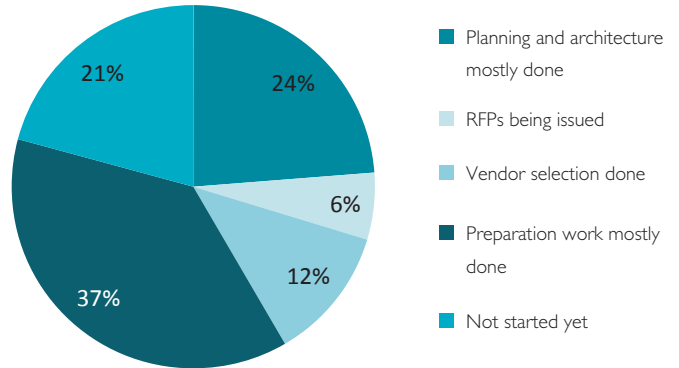


Figure-14

Preparing for Evolving Compliance Requirements

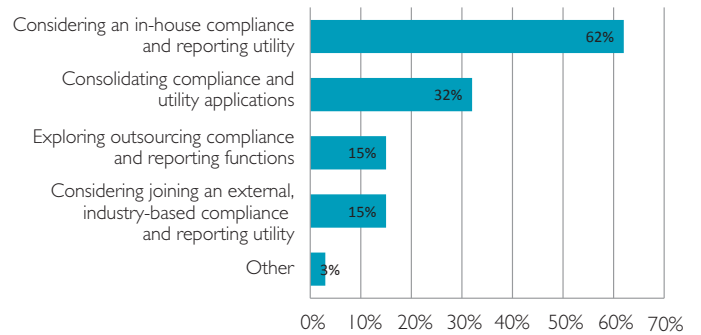


Figure-15

Our survey results confirm Sriram's impressions. Fully 30% said they're looking to outsource compliance and reporting functions or joining external industry-based utilities—although not exclusively. Nearly two-thirds are looking at creating in-house compliance and reporting utilities. In most cases, financial firms will strike a balance between in-house and outsourced solutions, Wipro believes.

5) Provision of enhanced, enterprise-wide visibility into liquidity More than merely a means of satisfying regulators, enhanced visibility into an institution's financial footing can become a source of competitive advantage. Such visibility is enabled by data-mart consolidation, harmonized data models, and the improvement and standardization of extract, transform and load (ETL) processes as well as risk and finance reconciliation.

Ultimately, the banks and other financial firms best able to exploit and deliver on these factors not only will shine in the eyes of regulators, but they will, by harnessing the business intelligence these systems can provide, also position themselves for success in the marketplace when the skies finally clear.

Wipro's Risk and Compliance Practice

Recognizing the critical regulatory imperatives across global banking today, Wipro has created the Risk and Regulatory Compliance Practice with a stated goal to enable, assist and partner our customer banks and financial institutions in developing integrated risk management capabilities, designed to drive efficiency, provide better value to stakeholders and drive higher business performance in an uncertain environment.

The Practice comprises of qualified practitioners and consultants with extensive business experience in developing frameworks, models, IT design and implementation experience across risks (credit, market, operational, counterparty, liquidity risks) and compliance initiatives like Basel II, Basel III, Dodd-Frank Act, FATCA, KYC/AML, cards and mortgages compliance, trading compliance, fraud prevention, etc.. Wipro's solutions, service offerings and accelerators cover the complete spectrum of risk and compliance initiatives across the BFS industry and enable our customers in optimizing the efficiency and effectiveness of their risk and compliance implementations.

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